

by paragraphs (b) to (f), inclusive, of this section.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 8687, 61 FR 60550, Nov. 29, 1996]

§ 1.863-6 Income from sources within a foreign country.

The principles applied in sections 861 through 863 and section 865 and the regulations thereunder for determining the gross and the taxable income from sources within and without the United States shall generally be applied in determining the gross and the taxable income from sources within and without a particular foreign country when such a determination must be made under any provision of Subtitle A of the Internal Revenue Code, including section 952(a)(5). This section shall not apply, however, to the extent it is determined by applying § 1.863-3 that a portion of the taxable income is from sources within the United States and the balance of the taxable income is from sources within a foreign country. In the application of this section, the name of the particular foreign country shall be used instead of the term *United States*, and the term *domestic* shall be construed to mean created or organized in such foreign country. In applying section 861 and the regulations thereunder for purposes of this section, references to sections 243 and 245 shall be excluded, and the exception in section 861(a)(3) shall not apply. In the case of any item of income, the income from sources within a foreign country shall not exceed the amount which, by applying any provision of sections 861 through 863 and section 865 and the regulations thereunder without reference to this section, is treated as income from sources without the United States. See § 1.937-2T for rules for determining income from sources within a possession of the United States.

[T.D. 9194, 70 FR 18928, Apr. 11, 2005]

§ 1.863-7 Allocation of income attributable to certain notional principal contracts under section 863(a).

(a) *Scope*—(1) *Introduction*. This section provides rules relating to the source and, in certain cases, the character of notional principal contract income. However, this section does not

apply to income from a section 988 transaction within the meaning of section 988 and the regulations thereunder, relating to the treatment of certain nonfunctional currency transactions. Notional principal contract income is income attributable to a notional principal contract. A notional principal contract is a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts. An agreement between a taxpayer and a qualified business unit (as defined in section 989(a)) of the taxpayer, or among qualified business units of the same taxpayer, is not a notional principal contract, because a taxpayer cannot enter into a contract with itself.

(2) *Effective date*. This section applies to notional principal contract income includible in income on or after February 13, 1991. However, any taxpayer desiring to apply paragraph (b)(2)(iv) of this section to notional principal contract income includible in income prior to February 13, 1991, in lieu of temporary Income Tax Regulations § 1.863-7T(b)(2)(iv) may (on a consistent basis) so choose. See paragraph (c) of this section for an election to apply the rules of this section to notional principal contract income includible in income before December 24, 1986.

(b) *Source of notional principal contract income*—(1) *General rule*. Unless paragraph (b) (2) or (3) of this section applies, the source of notional principal contract income shall be determined by reference to the residence of the taxpayer as determined under section 988(a)(3)(B)(i).

(2) *Qualified business unit exception*. The source of notional principal contract income shall be determined by reference to the residence of a qualified business unit of a taxpayer if—

(i) The taxpayer's residence, determined under section 988(a)(3)(B)(i), is the United States;

(ii) The qualified business unit's residence, determined under section 988(a)(3)(B)(ii), is outside the United States;

(iii) The qualified business unit is engaged in the conduct of a trade or business where it is a resident as determined under section 988(a)(3)(B)(ii); and

(iv) The notional principal contract is properly reflected on the books of the qualified business unit. Whether a notional principal contract is properly reflected on the books of such qualified business unit is a question of fact. The degree of participation in the negotiation and acquisition of a notional principal contract shall be considered in this determination. Participation in connection with the negotiation or acquisition of a notional principal contract may be disregarded if the district director determines that a purpose for such participation was to affect the source of notional principal contract income.

(3) *Effectively connected notional principal contract income.* Notional principal contract income that under principles similar to those set forth in § 1.864-4(c) arises from the conduct of a United States trade or business shall be sourced in the United States and such income shall be treated as effectively connected to the conduct of a United States trade or business for purposes of sections 871(b) and 882(a)(1).

(c) *Election—(1) Eligibility and effect.* A taxpayer described in paragraph (b)(2)(i) of this section may make an election to apply the rules of this section to all, but not part, of the taxpayer's income attributable to notional principal contracts for all taxable years (or portion thereof) beginning before December 24, 1986, for which the period of limitations for filing a claim for refund under section 6511(a) has not expired. A taxpayer not described in paragraph (b)(2)(i) of this section that is engaged in trade or business within the United States may make an election to apply the rules of this section to all, but not part, of the taxpayer's income described in paragraph (b)(3) of this section for all taxable years (or portion thereof) beginning before December 24, 1986, for which the period of limitations for filing a claim for refund under section 6511(a) has not expired. If a taxpayer makes an election pursuant to this paragraph (c)(1) in the time and manner provided in paragraph (c) (2) and (3) of this section, then, with re-

spect to such taxable years (or portion thereof), no tax shall be deducted or withheld under sections 1441 and 1442 with respect to payments made by the taxpayer pursuant to a notional principal contract the income attributable to which is subject to such election. The election may be revoked only with the consent of the Commissioner.

(2) *Time for making election.* The election specified in paragraph (c)(1) of this section shall be made by May 14, 1991.

(3) *Manner of making election.* The election described in paragraph (c)(1) of this section shall be made by attaching a statement to the tax return or an amended tax return for each taxable year beginning before December 24, 1986, in which the taxpayer accrued or received notional principal contract income. The statement shall—

(i) Contain the name, address, and taxpayer identifying number of the electing taxpayer;

(ii) Identify the election as a “Notional Principal Contract Election under § 1.863-7”; and

(iii) Specify each taxable year described in paragraph (c)(1) of this section in which payments were made.

(d) *Example.* The operation of this section is illustrated by the following example:

Example. (1) On January 1, 1990, X, a calendar year domestic corporation, entered into an interest rate swap contract with FZ, an unrelated foreign corporation. X does not have a qualified business unit outside the United States. Under the contract, X is required to pay FZ fixed rate dollar amounts, and FZ is required to pay X floating rate dollar amounts, each determined solely by reference to a notional dollar denominated principal amount specified under the contract. The contract is a notional principal contract under § 1.863-7(a) because the contract provides for the payment of amounts at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for a promise to pay similar amounts.

(2) Assume that during 1990 X had notional principal contract income of \$100 in connection with the notional principal contract described in (1) above. Also assume that the contract provides that payments more than 30 days late give rise to a \$5 fee, and that X receives such a fee in 1990. Under paragraph (b)(1) of this section, the source of X's \$100 of income attributable to the swap agreement is domestic. The \$5 fee is not notional principal contract income.

(e) *Cross references.* See §1.861-9T(b) for the allocation of expense to certain notional principal contracts. For rules relating to the source of income from nonfunctional currency notional principal contracts, see §1.9 88-4T. For rules relating to the taxable amount of notional principal contract income allocable under this section to sources inside or outside the United States, see §1.863-1(c).

[T.D. 8330, 56 FR 1362, Jan. 14, 1991]

§ 1.863-8 Source of income derived from space and ocean activity under section 863(d).

(a) *In general.* Income of a United States or a foreign person derived from space and ocean activity (space and ocean income) is sourced under the rules of this section, notwithstanding any other provision, including sections 861, 862, 863, and 865. A taxpayer will not be considered to derive income from space or ocean activity, as defined in paragraph (d) of this section, if such activity is performed by another person, subject to the rules for the treatment of consolidated groups in §1.1502-13.

(b) *Source of gross income from space and ocean activity—(1) Space and ocean income derived by a United States person.* Space and ocean income derived by a United States person is income from sources within the United States. However, space and ocean income derived by a United States person is income from sources without the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in a foreign country or countries.

(2) *Space and ocean income derived by a foreign person—(i) In general.* Space and ocean income derived by a person other than a United States person is income from sources without the United States, except as otherwise provided in this paragraph (b)(2).

(ii) *Space and ocean income derived by a controlled foreign corporation.* Space and ocean income derived by a controlled foreign corporation within the meaning of section 957 (CFC) is income from sources within the United States. However, space and ocean income derived by a CFC is income from sources

without the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in a foreign country or countries.

(iii) *Space and ocean income derived by foreign persons engaged in a trade or business within the United States.* Space and ocean income derived by a foreign person (other than a CFC) engaged in a trade or business within the United States is income from sources within the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed within the United States.

(3) *Source rules for income from certain sales of property—(i) Sales of purchased property.* When a taxpayer sells purchased property in space or international water, the source of gross income from the sale generally will be determined under paragraph (b)(1) or (2) of this section, as applicable. However, if such property is inventory property within the meaning of section 1221(a)(1) (inventory property) and is sold for use, consumption, or disposition outside space and international water, the source of income from the sale will be determined under §1.861-7(c).

(ii) *Sales of property produced by the taxpayer—(A) General.* If the taxpayer both produces property and sells such property, the taxpayer must allocate gross income from such sales between production activity and sales activity under the 50/50 method. Under the 50/50 method, one-half of the taxpayer's gross income will be considered income allocable to production activity, and the source of that income will be determined under paragraph (b)(3)(ii)(B) or (C) of this section. The remaining one-half of such gross income will be considered income allocable to sales activity, and the source of that income will be determined under paragraph (b)(3)(ii)(D) of this section.

(B) *Production only in space or international water, or only outside space and international water.* When production occurs only in space or international water, income allocable to production activity is sourced under paragraph